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16 January 2004

Ms. Connie Fung
Assistant Legal Adviser
Legislative Council Secretariat
(Fax No. 2877 5029)

Dear Ms. Fung,

Subcommittee on
Proposed resoluation under section 3(1) of the
Loans Ordinance

Please find attached the Administration's response to the questions raised by Hon. Audrey EU in her letter of 14 January 2004. Chinese version will follow.

Yours sincerely,

(Tommy Yuen)
for Secretary for Financial Services
and the Treasury

<u>Proposed Securitisation of Revenue</u>
<u>from Government Toll Tunnels & Bridges (*Toll Roads*)</u>

Securitisation - Background

The proposed securitisation will involve the issuance of notes or bonds (***Securitised Bonds***) backed by the net revenues received by Government from Government-owned Toll Roads. The Securitised Bonds will be rated by international credit rating agencies, such as Standard & Poor's, at a high investment-grade level, such as A+ or AA-. The credit ratings of the Securitised Bonds will reflect the historical performance of the Toll Roads and the ability of the Toll Roads to generate sufficient traffic volume and thus revenue in the future to repay the Securitised Bonds. The Government will not guarantee returns or repayment of the Securitised Bonds. Only the net toll revenues will be securitised, and then only for a limited period. Investors of the Securitised Bonds will only be entitled to interest payments, and the repayment of their principal. Once the Securitised Bonds are fully repaid, 100% of the net toll revenues will continue to be received by the Government.

Unlike equity IPO transactions, the proposed securitisation does not involve the sale of the Toll Roads by Government, or the issuance of shares in a company that owns the Toll Roads. Government will retain full ownership of the Toll Roads, including control over the arrangements with operators and the right to set toll rates/tariffs. If total revenue from the Toll Roads exceeds expectations or increases substantially after securitisation, the Government will retain the rights to any revenues generated in excess of the amount required to give investors their interest returns and principal repayment. Any "upside" of the Toll Roads will, therefore, flow back to Government, rather than to the investors. Therefore, the securitisation is a very different arrangement to a privatization or equity IPO.

<u>A. Options considered</u>

1. Whether securitisation of future proceeds from toll roads and tunnels is a justifiable means of fund raising (in terms of costs and efficiency) when compared to a simple debt issue or IPO?

Government has considered all the solutions available to meet its funding and disposal objectives, including assessing the diversity of available funding sources and those which enable Government to retain operating control of the Toll Roads and the freedom to manage future policy changes.

As noted above, unlike an equity IPO, the securitisation will enable Government to retain full ownership and control of the Toll Roads. An equity IPO may significantly restrict Government's ability to manage its transport policy, set toll rates accordingly and would impact directly its relationship with the Toll Road operators. Furthermore, Government would no longer retain the upside from future growth in toll revenues. An equity IPO is also likely to involve significantly greater time and costs to execute, and thus would not meet current objectives. The costs of an equity IPO include significantly higher initial arrangement, legal and accounting costs.

A conventional Government bond would involve Government guaranteeing an interest return and ultimate repayment of principal to investors. This is not the case for the Securitised Bonds, which will not be direct financial obligations of the Government, and will not be guaranteed by the Government. Although the interest costs of the securitisation will be a function of market conditions, all things being equal, the rating of the Securitised Bonds (which is expected to be the same as that of Government) should ensure access to the widest possible investor base, resulting in interest costs which are highly competitive with those for a conventional Government Bond notwithstanding the fact that the Securitised Bonds will not be guaranteed by Government.

The costs of arranging the securitisation are expected to be similar to those of a conventional bond issue. These costs relate mainly to the initial expenses incurred in relation to the issuance of Securitised Bonds, such as fees paid to arranging investment banks, placing banks and brokers, legal and tax advisers and the credit rating agencies. Annual fees of the credit rating agencies for the securitisation are also expected to be similar to those for a conventional bond issue. Such costs can only be finalised once the Government has appointed an arranger for the securitisation, through its normal competitive bidding process.

2. Have all fund raising alternatives been fully considered?

Government has carefully considered all available alternatives and has received advice from various sources, including its internal and external financial advisers. The review of alternative options, such as an outright sale of the Toll Roads or an IPO, has been carried out in the context of Government's objectives, both current and future, as they relate to management of fiscal policies and the development of Hong Kong's capital markets. Government has concluded that the proposed securitisation provides an opportunity (in the structure and form set out in the Legislative Council Brief) to achieve the objectives of Government to raise one-off capital revenue for the Capital Works Reserve Fund, diversify investment choices to both retail and institutional investors in Hong Kong and stimulate further development of Hong Kong's debt capital markets.

3. Has Government done a detailed analysis, comparing the costs and impact to the financial markets by doing securitisation vs debt issuance? What is the initial comment of the rating agency as the rating of the bonds would affect the fund cost?

And

4. Whether the credit ratings of the toll roads and tunnels to be given by independent credit rating agencies was considered by HSBC not qualified to

warrant a successful debt issuance, and therefore some forms of collaterals are necessary to secure the issuance of note.

The Government has had thorough and extensive discussions with its financial adviser, the Department of Justice and external legal advisers in preparation for the proposed securitisation. The outcome of these discussions suggests that the proposed securitisation of Toll Roads would be well received by the Hong Kong and international capital markets. This view is also supported by other investment banks with which Government has had discussions.

Whilst market development is not the only objective of the securitisation, the issuance of revenue backed notes or Securitised Bonds will serve to further develop Hong Kong's debt capital markets, building on the work done recently by the Hong Kong Mortgage Corporation. This will benefit all market participants, including retail investors, by providing new and attractive investment alternatives. Ultimately, this will help maintain Hong Kong's position as an international financial centre, and a centre of sophistication and excellence in the debt capital markets.

Government and its financial adviser, HSBC, have consulted extensively with the major independent credit rating agencies (Standard & Poor's, Moody's and Fitch) about the possible rating for the securitisation. Feedback from all three major rating agencies is that, notwithstanding the absence of a Government guarantee, the proposed securitisation (as described in the Brief to Legislative Council) will be rated as highly as AA- or Aa3 (which is the same as Government's current rating) in Hong Kong Dollars. Such a rating level should ensure that the offering of the Securitised Bonds will be well received by investors, resulting in very competitive interest costs, akin to that which may be achieved by a conventional Government bond.

The proposed structure of the securitisation does not involve the provision of any additional collateral or security by Government, as the ratings level achievable based on the toll revenues alone will be sufficient to attract a large body of investors, at competitive interest rates for Government, as noted above.

5. If the Government is to give certain undertakings or to set out a concrete transport policy insofar as that may affect the traffic flow of the Toll Roads, and yet it may also have to adopt its transport policy in the light of Hong Kong's developing situation, would the securitisation put the Government in a position of conflict of interest?

We will build into the proposed securitisation mechanisms to retain flexibility in the future implementation of our transport policy. For example, we will retain an option to exclude a tunnel or toll road from the transaction altogether after an initial period to cater for possible development in the transport policy. We will also incorporate into the proposed securitisation mechanisms to minimize the tenor of the proposed Securitised Bonds. As such, the implementation of future transport policy will not be restricted by the securitisation. This is one of the key attractions of the securitisation when compared with other alternative ways of raising capital revenue.

<u>B. Securitisation Market</u>

The securitisation market in Hong Kong is one of the more developed and sophisticated markets in Asia, with the first securitisation launched over 10 years ago in 1993. This is supported by a sound legal system and a highly liquid market for bonds and syndicated loans. In the last three months of 2003 alone, HK$6 billion of securitisation were successfully closed in Hong Kong through two transactions (HK$3 billion mortgage backed securitisation and HK$3 billion taxi and public light bus loans securitisation).

Advice from our financial adviser is that the Hong Kong Dollar market has more than sufficient capacity to absorb the issuance of the HK$6 billion of Securitised Bonds. At this stage, however, Government has not ruled out issuance in the international markets and in foreign currencies, subject to further study.

1. The bod(ies) who are going to hold the notes before maturity, whether it is the ABS, or the market makers.

It is intended that the Securitised Bonds to be issued under the proposed securitisation will be offered to both retail and institutional investors packaged in a format which appeals to all segments of the investor community. Such bonds will be held by these investors until their maturity, although Government will seek to ensure that there will be a number of market makers available to enhance the liquidity and secondary trading of the Securitised Bonds post-closing.

2. Whether there will be an active second-hand market for the trading of the notes before their maturity, and if yes, whether Hong Kong is a market sophisticated enough for that?

And

3. The securitisation market in Hong Kong is at its infancy. Has HSBC, the arranger of the exercise, considered whether the Hong Kong market is ready and has the capacity to absorb one-off notes issue worth HKD 6 billion? What are the market risks involved?

There will be an active secondary market for the trading of the Securitised Bonds before their maturity, facilitated by the availability of market-makers (mainly, the major banks or investment banks) for both retail and institutional investors. As mentioned above, the Hong Kong market is one of the more sophisticated markets in Asia, with two successful transactions of HK$6 billion in the last three months of 2003 alone. The Hong Kong capital markets are generally very deep and liquid. Government has taken the views of the financial adviser and of other investment banks and does not expect any unusual market risks in relation to the proposed securitisation.

4. How much will be the total initial costs and the annual on-going operation costs (e.g. fees charged by the investment bank, trustee) of the securitisation?

Although the ancillary expenses and annual incidental costs associated with the implementation of the securitisation cannot be finalized until Government has analysed the competitive terms proposed by the shortlisted banks and appointed an arranger for the securitisation. In the meantime, the following is an estimate of such items:

(a) Ancillary Expenses: Between HK$10 to 15 million plus arrangement fees, which will be expressed as a % of proceeds and subject to competitive bidding process by the short-listed banks. These expenses are typical of those required for securitisations and other bond offerings (including retail bond offerings) for a transaction of this size, and include the fees and expenses of legal advisers, credit rating agencies, accounting and tax advisers, transaction administrator and trustee, and other parties required to implement the securitisation.

(b) Annual Incidental Costs: Approximately HK$1.5 million per year, payable to the trustee acting in the interests of investors, to the Issuer's auditors, to Hong Kong Monetary Authority's clearing house and to the credit rating agencies for their annual reviews and monitoring of the securitisation for the benefit of investors.

No investment banking fees will be payable once the securitisation has been closed.

<u>C. Control</u>

1. Please address the hindrance on the Government to determine the tariff once the securitisation of future revenue has been in place.

The ownership of the Toll Roads, including control over arrangements with operators and the right to set toll rates would continue to be retained by Government. The securitisation will be designed to allow Government maximum flexibility for implementation of future transport policy.

The securitisation will not hinder the freedom of Government to adjust toll rates should changes in policy require this. If as a consequence of a change in toll rate, there are changes to the toll revenues, the following scenarios illustrate the way in which the implications for investors and the Government will be handled:

(i) If toll rates are changed by the Government, leading to an overall **<u>increase</u>** in total net toll revenue from the Toll Roads:

- <u>Investors</u> will receive the same interest return and principal repayment over a shorter period of time.

- Government will receive the extra revenue at the end of the securitization, and the securitisation will be repaid over a shorter period.

(ii) If toll rates are changed by the Government, leading to an overall **decrease** in total net revenue from the Toll Roads:

- If the decrease is greater than a certain threshold, Government may be required to make certain payments to the securitisation, to compensate investors for the impact of the revenue reduction, if any such reduction occurs. The Government will discuss with the arrangers and credit rating agencies, upon their appointment, the extent of the risk they would accept in relation to future toll adjustment.
- Investors will receive the same interest return and principal repayment as originally projected.

Therefore, Government's rights in respect of the setting or adjustment of toll rates will not be affected by the securitisation. Investors will be protected from the risk of changes in overall toll revenues due to toll rate adjustments through payments to be made by Government, as necessary

2. Some of the tunnels such as Lion Rock and the Hung-Hom Cross Harbour tunnel have reached its maturity and the room for future revenue growth is questionable. Under such circumstances, the assets, in order to attract investors, might have to be sold at considerable discount or with guaranteed dividend. Will the return be as good as what the Government expects?

The proposed securitisation does not involve selling any of the tunnels or the bridge. Government is securitising the relevant net revenue from Toll Roads only, for a limited period. The Government retains full ownership of the tunnels and bridge before, during and after the securitisation. There is, therefore, no question of selling any asset at a discount or of Government providing any guaranteed dividend.

Unlike an equity IPO transaction (where investors expect future growth), the proposed securitisation will be funded by the issuance of Securitised Bonds which are debt instruments. Since investors in the Securitised Bonds are only entitled to interest returns and ultimately, repayment of principal, they will be attracted by the long and steady track record of historical performance, rather than prospects of growth. The long and steady performance of most of the Toll Roads such as the Lion Rock and Cross Harbour Tunnels is thus favoured by investors of the Securitised Bonds.

The Government will not be required to provide any guarantee of interest or principal with respect to the Securitised Bonds. Furthermore, Government will not be required to provide any guarantee on traffic volume, the risk of which will be assumed by investors in the Securitised Bonds.

Conversely, to the extent that traffic volume (and thus toll revenue) post-securitisation is higher than expected, Government (rather than investors) will be entitled to the better-than-expected performance:

- Investors will receive the same interest return and principal repayment over a shorter period of time.
- Government will receive the extra revenue at the end of the securitisation, and the securitisation will be repaid over a shorter period.

D. Deal Assessment

1. Whether the seller requires provision of guarantee for the pool, i.e. the securitized assets.

The proposed securitisation does not involve any guarantee from Government in relation to the Securitised Bonds.

2. Whether there is sinking fund payment (repayment) during the life of the bond. This may pose potential cash flow problem to the seller.

Under the proposed securitisation, Government will transfer the net toll revenue received from the Toll Roads to the securitisation to support the repayment of principal and interest to the investors. The transaction will, therefore, not pose any cash flow problems to the Government. The securitisation structure may establish, out of toll revenue transferred from Government, a sinking fund in its accounts prior to the maturity dates of each class or tranche of Securitised Bonds.

3. Whether there is any top-up deficiency requirement, i.e. what will happen if the cash flow from the asset is at risk? Does the seller need to top-up? If yes, this poses cash flow problem back to seller.

Investors assume the risk that there may not be sufficient revenue from the Toll Roads to repay the interest or principal on the Securitised Bonds (although the risk of such an event is remote given the very strong track record of performance, and the high credit ratings which will be assigned to the Securitised Bonds). Government will not be required to top-up any cash if there is a shortfall from the toll revenues to repay the investors of the Securitised Bonds except in circumstances as described in paragraph 7 of the Legislative Council Brief.

E. Selection of advisor / arranger

1. Will the appointment of HSBC as the adviser "AND" arranger pose an issue of possible conflict of interest, given the Advisor has the inroad to the deal so in theory have advantage over others?

Government has yet to appoint any arranger for this proposed securitisation pending the outcome of consideration of this issue by the Legislative Council.

Selection and appointment of the arranger will be conducted through an open and competitive bidding process. Interested financial institutions will be assessed on the basis of a number of objective selection criteria made known to them before they submit their proposals.

To ensure this transaction can benefit from top quality financial advice available in the market, the financial adviser for the initial stage of the transaction is not restricted from competing for the arranger’s role. Given the above established, open and competitive selection procedures, the financial adviser will not be given any undue advantage because of its previous advisory appointment.

2. What is the criterion of selecting the advisor and arranger? What is the selection process and who were the candidates?

All institutions registered on the list of financial consultants maintained by the Treasury Branch of the Financial Services and the Treasury Bureau of the Financial Services and Treasury Bureau had been invited to express interest in being appointed as the advisor or arranger of the proposed securitisation.

On the basis of the knowledge and experience of the institution in similar securitisation transactions locally and/or overseas, experience and expertise of the proposed assignment team to carry out the work involved, history and financial position of the institution plus its commitment to Hong Kong and its fee proposal, the adviser was selected through an open and competitive process. A similar process is being undertaken for selection of the arranger in the near future subject to the approval of the Legislative Council of the proposed resolution under the Loans Ordinance.